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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 1193

ST. FRANCIS HOSPITAL, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE DISTRICT OF
COLUMBIA*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 6-16) is reported in 42 B. T. A. 1004. The opinion of the Court of Appeals (R. 24-29) is reported in 125 F. (2d) 553.

JURISDICTION

The judgment of the Court of Appeals was entered February 2, 1942 (R. 30). The petition for a writ of certiorari was filed April 23, 1942 (R. 30).

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The withholding provisions of Section 144 of the Revenue Act of 1928, and Section 143 of the Revenue Act of 1932 are applicable to interest paid to individuals but not to interest paid to domestic corporations. The question presented is whether interest on a mortgage obligation paid to a domestic corporation as trustee and then distributed to participating beneficiaries is to be regarded as paid to the trustee or to the cestuis.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 10-16.

STATEMENT

In July 1930 the taxpayer's predecessor,¹ the Sisters of the Third Order of Saint Francis, executed a mortgage for \$1,100,000 to The Union Trust Company of Pittsburgh, a domestic corporation (R. 20, 22). The mortgage contained the common tax-free covenant whereby the taxpayer agreed to pay interest without deduction for income tax which it might be required to withhold to the ex-

¹ The debt was subsequently assumed by taxpayer (R. 21). The mortgage debt was always considered the debt of taxpayer, which made all interest payments thereon (R. 21).

tent of a tax of two percent, and to pay on behalf of the creditor income tax to the extent of two percent (R. 20). Shortly after the delivery of the mortgage The Union Trust Company of Pittsburgh executed and retained in its own files a "Declaration of Trust" which stated that the mortgage and mortgage bond were held in trust for the several estates interested to the extent of their contribution toward the principal (R. 21, 23, Ex. A). The Union Trust Company of Pittsburgh did not at that time notify the taxpayer that such a declaration of trust had been executed (R. 21). The semi-annual interest instalments were paid by the taxpayer to The Union Trust Company of Pittsburgh by a single check (R. 21). As these instalments were paid, the Trust Company distributed the interest among the participating estates and forwarded to the taxpayer ownership certificates (Treasury Form 1000) showing the payments to the several estates (R. 22).

The Commissioner determined that the taxpayer was required by Section 144 of the Revenue Act of 1928 and Section 143 of the Revenue Act of 1932 to pay withholding taxes upon the interest paid and asserted a deficiency for the years 1930, 1931, 1932, and 1933 in the amount of \$3,008.99 in tax and a penalty of \$752.25 (R. 3). The Board of Tax Appeals affirmed the Commissioner's determination (R. 6-16), holding that payments were made to the beneficiary estates and not to the trust company,

a domestic corporation. The Court of Appeals affirmed (R. 24-29).

ARGUMENT

The applicable sections of the Revenue Acts of 1928 and 1932 require that when a bond or mortgage contains a provision that the debtor will pay any portion of the tax imposed upon the creditor, the debtor shall withhold a tax equal to two percent of the interest, provided that the interest is payable to an individual, partnership, or foreign corporation, but not to a domestic corporation.² In the instant case, payment was made to The Union Trust Company, a domestic corporation, which then distributed the interest among the various participating estates. The question is whether, within the meaning of the Act, the payee was the trustee corporation, as holder of the legal title, or the cestuis as owners of the beneficial interest. If the payment is not deemed to have been made to the domestic corporation, the Act is applicable.

1. It is our position that interest is payable to a domestic corporation within the meaning of the Revenue Acts only when it is received by the corporation as its own taxable income and not when it is received by the corporation as agent or trustee

² The use of the word "withhold" in this section is somewhat misleading. When the mortgage contains a tax-free covenant, the practical effect of the statute is to require the debtor to pay the full amount of interest contracted for and to pay to the Government a tax amounting to two percent of the interest. See 5 Paul & Mertens, *Law of Federal Income Taxation*, Sec. 49.04.

for individuals or participating estates. The recipient of the interest for purposes of the withholding provisions is necessarily the person who would otherwise be taxed upon the interest as income. He is the payee although the interest may be collected by an agent or trustee on his behalf. The object of the withholding feature of the Revenue Acts was to permit creditors or bondholders who had bargained therefor to transfer a portion of their tax burden to their debtors or obligors. This statutory advantage should be available to all bond or mortgage holders, irrespective of whether, as is often the case, they receive interest through a corporate trustee as intermediary.

Similar provisions in Revenue Acts since 1918³ have been consistently interpreted by the Treasury as dependent for their application upon the status of the person who would be taxed on the interest received and not upon that of the intermediary.⁴

³ Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 221; Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 221; Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 221; Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 221.

⁴ This has been the Treasury practice. See Articles 363 through 369 and Article 374 of Regulations 45, promulgated under the Revenue Act of 1918; Articles 763 through 769 of Regulations 77, promulgated under the Revenue Act of 1932. Intervening regulations are to a similar effect.

The taxpayer places reliance upon a statement found in the 1940 Prentice-Hall Tax Service, Vol. 2, p. 18,239, Sec. 18,324, to the effect that the application of withholding provisions to trusts depends upon the status of the fiduciary and not that of the grantor or beneficiary. This statement is derived from I. T. 2605, X-2, Cum. Bull. 192 (1931),

This long continued administrative interpretation, during a period in which the law has been repeatedly reenacted, is entitled to great weight. *Brewster v. Gage*, 280 U. S. 327; *National Lead Co. v. United States*, 252 U. S. 140.

The fact that the mortgage provided that interest should be paid to the Union Trust Company is immaterial. Mortgages frequently provide that interest is to be paid to a corporate collecting agent which has no interest in the obligation and which acts as a mere conduit between the debtor and its creditors. The Trust Company did not receive the interest in its own behalf; it was under a duty to pay over the interest to the estates in accordance with their contribution to the principal of the loan.

The taxpayer argues (pp. 15-17) that since the interest was paid to the Trust Company as fiduciary for the individual estates and since it was required to make an income tax return on behalf of the estates, the interest was "payable to" a domestic corporation within the meaning of the Revenue Acts. This overlooks the facts that the Trust Company received the income only in a representative capacity and that when it made income tax returns on behalf of the estates, which are entities taxed as individuals (Section 162 of the Revenue

which was concerned with a different withholding provision (I. R. C. Sec. 143 (b)) relating to nonresident aliens. The object of such a provision is to prevent aliens from evading a tax. Since the purpose of permitting withholding in the case of tax-free covenant bonds is entirely different the ruling with respect to aliens is clearly inapplicable.

Act of 1928 and Section 161 of the Revenue Act of 1932), it returned the interest as their, not its own, income. For tax purposes, the estates, not the Trust Company, are the owners of the obligation.

The taxpayer also argues (p. 11) that Congress did not intend to impose upon the obligor the duty of determining the identity of the beneficiary, and that, accordingly, the status of the trustee-payee must control. But the statute contains an express provision for situations in which the owner of the obligation was unknown to the obligor; the obligor is then given an opportunity to protect himself by deducting an additional percentage of the interest.⁵ In any event, the taxpayer here knew the names of the owners of the obligations from the ownership certificates forwarded to it (R. 22).

2. The taxpayer urges (pp. 12-15, 17-21) that the Court of Appeals erred, (a) in that it failed to give force to the rule against splitting a cause of action without the consent of the obligor, and (b) in that it refused to give effect to the provisions of a Pennsylvania statute concerning the pooling and allocation of mortgages by trust companies. The rule

⁵ The last proviso in Sec. 144 (a) of the 1928 Act (see Appendix, *infra*, p. 11) reads as follows:

"* * * *Provided further*, That if the owners of such obligations are not known to the withholding agent the Commissioner may authorize such deduction and withholding to be at the rate of 2 per centum, or, if the liability assumed by the obligor does not exceed 2 per centum of the interest, then at the rate of 5 per centum."

against splitting a cause of action prevented the Trust Company from assigning to the participating estates the right to receive interest directly from the debtor or to take legal action to collect interest and principal. This rule does not prevent the assignment of the beneficial interest to the participating estates, but merely protects the obligor against a multiplicity of demands and suits. The Trust Company continued to exercise the powers of collection, but as trustee for the true owners, the participating estates, not in its own behalf. The ordinary corporate bondholder has no unlimited right to sue for interest or to collect principal on his own behalf but must rely upon the mortgage trustee to protect his interests. He is, none the less, considered the owner.

The Pennsylvania statute, Act of April 11, 1929, P. L. 216, Laws of Pennsylvania (1929), p. 512, allegedly disregarded, allowed trust companies to pool mortgages held by them and to allocate to the trust estates undivided interests in the pool; it provided that no participating estate should be deemed to have individual ownership of any mortgage in the pool; and it allowed trust companies to buy mortgages from the pool at market value and substitute other mortgages therefor. The purpose of the limitation upon "individual ownership" and the other provisions of the Pennsylvania statute was to allow trust companies to manage estates efficiently by pooling arrangements and to give the trust companies a greater flexibility

in management than they might otherwise have had. *Guthrie's Estate*, 320 Pa. 530; *Blair v. Pennsylvania Co.*, 24 D. & C. (Pa.) 490. But it was recognized that the Act involved merely the separation of the "legal and beneficial interest" (*Blair v. Pennsylvania Co.*, *supra*, at 493-494); it deprived the cestui of some powers of management, but not of his right to the proceeds of the interest. The statute does not purport to vest in trust companies, which have allocated interests in mortgages to trust estates, the right to receive interest on the mortgage loans as their own corporate income.

In any event, the peculiar nomenclature assigned by state law to given rights or types of ownership does not govern the application of the revenue laws if Congress intended to tax these rights or types of ownership. *Morgan v. Commissioner*, 309 U. S. 78; *Burnet v. Harmel*, 287 U. S. 103.

CONCLUSION

The decision below is correct. There is no conflict of decisions. No question worthy of review is presented. It is respectfully submitted, therefore, that the petition should be denied.

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MAY 1942.